Introduction to Profit and Loss Accounts and Balance Sheets

Specification Requirement -Understand the importance of the main items on a Profit and Loss Account and Balance Sheet of sole traders and partnerships.

Interpret simple Profit and Loss Accounts and Balance Sheets.

Understand the function and purpose of accounts in relation to internal and external stakeholders.

Introduction.

Analysis of both Profit and loss Accounts and Balance Sheets at A2 Level is is based on the use of accounting ratios. But what is important at AS Level is an understanding of both the structure of Profit and Loss Accounts and Balance Sheets and the importance of the main parts of these accounts. When it comes to commenting on accounts the requirements of the examiner are often based on an understanding of changes in a firms performance—so two years accounts can be shown side-by-side. Remember that Business Studies is not a maths exam, and the maths we use is quite straightforward.

We start our analysis of business accounts by looking at a simple Profit and Loss Account, typical of those presented in AS questions.We will look at how the account is constructed and how we can comment on the account.

A Simple Profit and Loss Account.

Below we can see the Profit and Loss Account for Frying Tonite for the year 2006-07. It is normal practice for Profit and Loss accounts to be produced for 12 months trading, but the 12 months do not have to run from January to December, they can cover any 12 consecutive months.

The Profit and Loss Account of Frying Tonite tells us the income the business has received from its trading activities over the last 12 months, and all the money it has spent performing these business activities over the same 12 months.

Because we are looking back over the past 12 months, Profit and Loss accounts are said to give a 'historic view'

Gross Profit and The Trading Account.

The first section of a Profit and Loss Account is sometimes referred to as the Trading Account. The Trading Account tells us what the sales of the company have been, and the direct costs of making those sales, the Cost of Sales.

	£	£
Sales		56,500
Less Cost of Sales		
Opening Stock	3,900	
Purchases	18,600	
Closing Stock	4,700	
		17,800
Gross profit		38,700
Less Expenses		
Wages	17,880	
Rent	4,600	
Rates	2,350	
Travel	2,600	
Sundries	860	
Electricity	,300	
Total Expenses		29,590
Net Profit		9,100

When we take the Cost of Sales away from the Sales of a company the figure we are left with is known as **Gross Profit.** This is the first figure of real importance.

Note When you look in more depth at Profit and Loss Accounts you will see a number of different names for profit, such as Profit Before Interest and Taxation, Trading Profit and so on, what is important now are just two types Gross Profit and Net Profit.

On the next page we can see the Trading Account for Frying Tonite, and an explanation of how the Gross Profit figure has been calculated.

Calculation of Gross Profit

	£	£
Sales		56,500
Less Cost of Sales		
Opening Stock	3,900	
Purchases	18,600	
Closing Stock	4,700	
		17,800
Gross profit		38,700

The first line in a Profit and Loss Account always gives the businesses trading income for the year, that is the revenue gained from the goods the business has sold, or the services it has provided. Trading income can be called different things, eg Sales, or Revenue or Income, or Turnover but they all mean the same thing.

For Frying Tonite £56,500 is the total income received for their sales of chips, fish, pies etc. during the year 2006-07.

Cost of Sales. These are the direct costs of purchasing the stock that is used in sales, for Frying Tonite this would include fish, oil, potatoes etc.

To calculate Cost of Sales, we must first add opening stock, that is the stock the business has at the beginning of the year, to purchases the business has made during the year. Once we have done this take away closing stock, that is stock left over at the end of the year. We take away closing stock as it has not yet been sold or used, so it is not part of cost of sales.

Cost of Sales =
Opening Stock + Purchases − Closing Stock

So for Frying Tonite the calculation would be:

£3,900 + £18,600 - £4,700 = £17,800

We place the figure for Cost of Sales in the second column , below the Sales figure.

Gross Profit. This figure is calculated by taking Cost of Sales away from Sales.

For Frying Tonite sales are £56,500, Cost of Sales are £17,800, so:

£56,500 - £17,800 = £38,700

Gross Profit Explained.

Gross Profit is an indicator of how efficient the firm is at making and selling it's product. But the figure for Gross Profit on its own does not help us judge the level of efficiency, after all a large firm is likely to have a much higher Gross Profit figure than a small firm. But the small firm could be better run, have less stock damaged, and buy it's raw materials cheaper. What the examiners want at this stage is an understanding of two things

- what Gross Profit measures - how efficient to firm is at managing it's cost of sales,
- how to calculate Gross Profit

Net Profit.

Net Profit is often referred to as 'the bottom line' in business. This is for two reasons, firstly on a simple presentation of a Profit and Loss Account, it is the actual bottom line, and secondly, the Net Profit figure tells us the actual profits of the business after all costs

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Total Expenses		29,590
Net Profit		9,100

have been paid. How we calculate Net profit is shown below.
We have already calculated the business's' Gross Profit.
Net we have to allow for expenses. Expenses are the indirect costs that the business incurs. These expenses are costs not directly linked to producing the good or service that the firm sells. Examples of expenses include rent, interest payments, electricity and so on.

The Total Expenses figure is placed in the second column, beneath the figure for Gross Profit. To find Frying Tonite's Net Profit will have to total these expenses and take them away from Gross Profit

To calculate Net Profit, we simply take the figure for Total Expenses away from the Gross Profit figure.

For Frying Tonite, Gross Profit is £38,700, Expenses are £29,590. So:

£38,700 - £29,510 = £9,110 Net Profit.

Net Profit Explained.

Net Profit is an indicator of how efficient the firm is overall, this is because we include all the firms revenues and expenses in its calculation. But like the figure for Gross Profit, Net Profit on its own does not help us judge the level of efficiency, after all a large firm is likely to have a much higher Net Profit figure than a small firm. But the small one could be better run, have less stock damaged, and buy its raw materials cheaper, and manage its expenses better. But as with Gross Profit what the examiners want at this stage is an understanding of two things

- what Net Profit measures - how efficient to firm is at managing all of it's costs,
- how to calculate Net Profit

Introduction to Balance Sheets

What is a Balance Sheet?

The first point to note about Balance Sheets is that they are a picture of what a business "owns, owes, and is owed" at a specific point in time. They are drawn up on a specific date, normally the last trading day of a business's financial year, and the contents of the Balance Sheet are a picture of the firms situation on that date.

On the Balance Sheet we see the buildings a business owns, the equipment it uses, the stock it holds, we how much money the business is owed, and how much money the business owes. We also see where the money came from to buy all the assets of the business, this funding is the 'balancing part' of the balance sheet.

Definitions of parts of the Balance Sheet .

Fixed Assets.
The Fixed Assets of a business are things the business owns which have a long-term role in the operation of the business. The business would not normally sell Fixed Assets unless they were being replaced with newer or more efficient equivalents. Examples of Fixed Assets are land, buildings, machinery, equipment, vehicles.

Fixed assets can also be 'intangibles', such as Brand Valuations or Goodwill (goodwill is the difference between the purchase price of a business and its asset valuation). Fixed Assets appear at the top of the Balance Sheet, and are totalled to give a Total Fixed Assets figure. For Frying Tonite the Fixed Assets include buildings, equipment (deep fat fryers, fixtures and fittings etc.) and a delivery van.

As a simple exercise try listing what the Fixed Assets of your school or college might be. What are the fixed assets of the Water Supply companies? The Electricity Generators? Or, and this is slightly more difficult, the Fixed Assets of your local football club?

As we saw with Fixed Assets, assets are goods the business owns. Current Assets are also goods the business owns, but the word 'current' indicates that

these goods are likely to change in the normal course of business. Through normal trading the value of Current Assets will both rise and fall.

Using Frying Tonite as an example, if a customer buys fish and chips, the amount of stock (fish and chips) will fall, but the amount of cash in the till will rise. This type of change is happening all the time in business, and is the main reason why the Balance Sheet is a view of what the business owns, owes and is owed, at a specific point in time.

Stock and Cash are simple to understand as Current Assets. Debtors are a little more difficult. If a business sells a good but does not receive immediate payment for the good then a Debtor is created. For example Frying Tonite has a contract to supply meals to a local factory. Frying Tonite invoices the factory (sends a bill to the factory), once a month for the meals supplied during the previous month. The invoice requires payment within 30 days. Until this invoice is paid a debtor is created, when the money is received the debtor disappears and instead Frying Tonite has increased cash or money in the bank.

Because the debt is expected to be paid in the normal course of business we can say it is a Current Asset. Apart from businesses who deal only in cash or cheque payments, all businesses will have debtors. An important aspect of business management is making sure debtors pay on time so that the business receives payment when it is due.

Current Assets and Current Liabilities

Liabilities are the opposite of assets. Liabilities are what a business owes. Current Liabilities happen to all businesses, they occur as part of normal business practice. When a delivery is received by a business (200lb of potatoes to Frying Tonite), the normal practice is for the supplier to invoice (bill) the buyer for the products supplied. The invoice may require payment in 14 or 30 days, (or even longer). Until the invoice is paid the business will have a liability, and as they are liable to pay in the normal course of business, it is a Current Liability. All debts that are due for repayment within 12 months are current liabilities. Another typical example of a current liability is an overdraft.

A typical simple Balance Sheet.

Frying Tonite Balance Sheet as at 31st of December 2007

	£	£
Fixed Assets		
Buildings	30,000	
Equipment	12,000	
Vehicles	6,000	
Total Fixed Assets	**48,000**	**48,000**
Current Assets		
Stock	4,700	
Debtors	1,200	
Cash at Bank	950	
Total Current Assets	**6,850**	**6,850**
Current Liabilities		
Creditors	3,700	
Overdraft	0	
Total Current Liabilities	**3,700**	**3,700**
Net Current assets		**3,150**
Total Assets Employed		**51,150**
Financed By		
Owners Capital	**32,000**	
Reserves	**7,150**	
Bank loan	**12,000**	
Total	**51,150**	

The Net Current Assets figure is simply the difference between Current Assets and Current Liabilities.

We calculate Net Current Assets by taking Current Liabilities away from Current Assets. If Current Liabilities are greater than Current Assets then Net Current Assets will be a minus figure. It is normal for minus figure to be shown in brackets in accounts, so if a firm's Net Current assets were -£3,269, we would show this in accounts as (£3,269).

Total Assets Employed.
This gives us the net value of all the assets currently being used by the business. The Total Assets

Calculating Total Fixed Assets
To obtain the figure for Total Fixed Assets, we simply add together the values of each individual Fixed Asset. The total is then shown in the second column of the Balance Sheet. We show the total in a second column to help with our later calculations and to add clarity to the presentation of the Balance Sheet.

Fixed Assets		
Buildings	30,000	
Equipment	12,000	
Vehicles	6,000	
Total Fixed Assets	**48,000**	**48,000**

Calculating Net Current Assets and Total Assets Employed
The first step is to total Current Assets. To do this simply add them together and place the total in the We must then total Current Liabilities. Just add them together and place the total in the second column.

Total Fixed Assets		**48,000**
Current Assets		
Stock	4,700	
Debtors	1,200	
Cash at Bank	950	
Total Current Assets	**6,850**	**6,850**
Current Liabilities		
Creditors	3,700	
Overdraft	0	
Total Current Liabilities	**3,700**	**3,700**
Net Current assets	**3,150**	**3,150**
Total Assets Employed		**51,150**

The total for Current Assets and Current Liabilities are now directly beneath each other in the second column. Take the Current Liabilities figure from the Current Assets figure . **We will now have the figure for Net Current assets.** Remember that if Current Liabilities are greater than Current Assets the answer will be a minus! (Note. Negative figures are often bracketed on accounts).

We can now calculate the Total Assets Employed figure. To obtain this we simply take the figure for Fixed Assets and add to this the total for Net Current Assets. Note. If the figure for Net Current Assets is a minus, we must take this way from Fixed Assets to obtain the

Financing Figure

We have already seen that the Total Assets Employed is one side of the Balance Sheet, the other side is the Financed by figure, this tells us where the money (capital) has come from to finance the business.
There are threemain sources of capital, which are shown on the Balance Sheet for Frying Tonight, these are ;

- Owners Capital

Financed By	
Owners Capital	**32,000**
Reserves	**7,150**
Bank loan	**12,000**
Total	**51,150**

- Reserves
- Bank Loan

Owners Capital. This is money that the owner has put into the business, it has come from his or her own resources. If the business was a partnership this section may be called Partners Capital and if the business was a limited company then the name would be Shareholders Capital.

Reserves or Retained Profit. This is money that has been kept in the business from profits made by the business. Frying Tonite made a profit of £9110 last year. The owner may decide to reinvest part of this back into the business to help it grow and become more profitable in the future. Reserves are not normally held as cash, but are used for buying assets for the business. If a reserves or retained profit figure is shown this means that part of the profits made in previous years have been reinvested in the business.

Bank Loans or Long Term Liabilities. Frying Tonite have a loan from the bank of £12,000, this has been used to fund part of the assets of the business. Bank loans are Long Term Liabilities, they have to be repaid more than 1 year into the future.

Why Prepare Accounts?

All businesses should prepare full sets of accounts.
There are a number of reasons why this should be done:

- Legal requirements – this applies to all limited companies. The form and timing of presentation of accounts, is laid down by law and by the accounting bodies.

- Tax requirements – if a firm's turnover is more than £15,000 then a full set of accounts can be requested by the Inland Revenue.

- To accurately calculate profit, liabilities and assets, only by doing this will the business owners understand how well the business is performing.

- Accounts can be used in business planning by the owners to estimate availability of capital for growth, or judge the need for borrowing or new investors.

- Accounts will be required if the business is seeking investors or loans. Potential investors will want to see how well the business is performing, and the main basis of decisions made will be the firms accounts. The same goes for the bank manager.

- Accounts are useful if credit is required. When buying on credit from a new supplier the supplier may request to view accounts before granting credit.

Exam Question Guidance

In examinations you may be given figures for the current years trading and the previous year and asked to compare these sets of figures. In this situation you should try to give your answers some proportionality. So for example, do not just say ' net profit has increased by £6,000', say instead that 'net profit has increased by £6,000, a 20% rise on the previous year' Also be aware of factors such as inflation, growth of markets and success of competitors, which will may influence your comments on the performance of the firm.

For example you might calculate a growth of sales or net profit of 10%, this might look good, but what if inflation is 7%, this means that the real growth has only been 3%. Also you should add the proviso that comment is limited by lack of information. How well have competitors done? How much has the market grown by? For example a games software firms growth rate of 5% a year over the last 5 years may appear impressive, but many major software companies have seen increases of 10%+ over the same period.

Notes